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SCSC - Q1 2015 ScanSource Inc Earnings Call

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CORPORATE PARTICIPANTS

Mary Gentry *ScanSource, Inc. - VP, Treasurer, and IR*

Mike Baur *ScanSource, Inc. - CEO*

Charlie Mathis *ScanSource, Inc. - SVP, CFO*

CONFERENCE CALL PARTICIPANTS

Chris McGinnis *Sidoti & Company - Analyst*

Keith Housum *Northcoast Research - Analyst*

PRESENTATION

Operator

Welcome to the ScanSource quarterly earnings conference call. All lines have been placed in a listen-only mode until the question and answer session. Today's call is being recorded. (Operator Instructions). I would now like to turn the call over to Mary Gentry, Vice President, Treasurer, and Investor Relations. Ma'am, you may begin.

Mary Gentry - *ScanSource, Inc. - VP, Treasurer, and IR*

Thank you. And welcome to ScanSource's earnings conference call for the quarter ended September 30, 2014. With me today are Mike Baur, our CEO, and Charlie Mathis, our CFO. We will review operating results for the quarter and then take your questions.

A slide presentation that accompanies our comments and webcast is posted in the investor relations section of our website. Certain statements made on this call will be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties that could cause actual results to differ materially from such statements. These risks and uncertainties include, but are not limited to, those factors identified in the release and in ScanSource's SEC filings.

These forward-looking statements represent our views only as of today, and should not be relied upon as representing our views as of any subsequent date. ScanSource undertakes no duty to update any forward-looking statements to actual results or changes in expectations. We will be discussing both GAAP and non-GAAP results during our call and have provided reconciliations between these amounts in our slide presentation and in the press release. These reconciliations can be found on our website and have also been filed on Form 8-K.

Mike Baur will now begin our discussion with an overview of our results.

Mike Baur - *ScanSource, Inc. - CEO*

Thanks, Mary, and thank you for joining us today. Let's start with the highlights for first quarter on slide 3 of our presentation.

We had another strong quarter, with both sales and EPS above our expected range. Our teams achieved record net sales for the quarter. Sales growth accelerated to 8% year-over-year with growth in worldwide barcode and security, and our worldwide communications and services segment.

We are making strategic investments in our business, including acquisitions in attractive growth markets with higher operating margins. Since we talked with you last quarter, we successfully completed our acquisition of Imago Group plc, Europe's leading value-added video and voice communications distributor. We welcome Ian Vickerage and his team to ScanSource and look forward to continuing its focus on driving growth of video and voice communication solutions in Europe.

We expect the addition of Imago's customers and vendors to be almost entirely incremental to the existing ScanSource Europe voice and data business. This acquisition will allow ScanSource to complete the buildout of our communication strategy across the major countries in Europe with our key vendors Polycom, Avaya, and ShoreTel. With the acquisition, we added approximately 120 employees in five locations across Europe. Imago's net sales for the 12 months ended July 31, 2014 total approximately $80 million.

In August, we announced agreement to acquire Network One, Brazil's leading value-added distributor. Network One currently has over 60 vendors, 8000 customers, and 365 employees. Network One would be the largest company that ScanSource has acquired to date. Network One's estimated sales for calendar year 2014 are estimated to be $340 million.

We are excited about this opportunity to expand our existing successful value-added distribution business in Brazil, with the addition of incremental technology solutions, vendors, and customers. For both ScanSource and Network One, business is continuing as usual as we are in the process of negotiating a definitive agreement with a closing planned by the end of the calendar year.

Our strategic investments in our business include adding skilled and industry experienced talent to build and grow our higher-margin opportunities. Over the past year, we have added headcount in these areas such as our international markets, 3-D printing, security, and POS payment terminals. These investments take time and are expected to generate strong returns in the future.

ScanSource is positioned for growth as we are investing not only in acquisitions and talent, but also our worldwide infrastructure. This will include all of the areas that add value to our business including our customer and vendor facing systems. This will enable us to improve the experience for our customers and vendors as we continue to grow and gain efficiencies at the same time.

The additional investment in our IT systems will provide our management team better decision-making information as the business continues to grow globally. And, of course, the key to making these investments is a strong balance sheet and strong operating performance as we demonstrated this quarter.

With that, I will turn the call over to Charlie to discuss our financial results in more detail and our outlook for second quarter fiscal year 2015.

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Thanks, Mike. The financial information I will be discussing can be found on slides 4 through 9 of our presentation.

As Mike mentioned, we are pleased to have completed our acquisition of Imago in September 19 and our first quarter results include Imago for 7 business days, which had minimal impact on our first quarter results. With the acquisition of Imago, as well as the planned acquisition of Network One this quarter, we are discussing our operating results and will be discussing in future quarters our operating results in terms of GAAP and non-GAAP measures.

The non-GAAP measures exclude acquisition costs, the amortization of intangible assets, and the change in fair value of contingent considerations. We believe that these non-GAAP measures provide better comparisons of our operations and will be helpful in understanding both our current performance and forecasts for future periods.

Net sales for the first quarter totaled $792 million, a record sales quarter and an 8.2% increase over the prior year quarter. Our worldwide barcode and security segment had another record sales quarter with 11.2% year-over-year growth, and our worldwide communications and services sales grew 3.4%. Our international sales were especially strong, growing 12.9% driven by our POS and barcode business in Europe and Latin America, including Brazil. This quarter, foreign currency translation had a minimal impact on sales.

Turning to profitability, our first quarter 2015 gross profit margin of 9.8% reflects the mix of business and higher volume of big deals. The gross profit margin for the quarter -- for the prior year quarter was 10.5%, higher than we expected to maintain going forward, and as I'd indicated in last year's call. The first quarter 2014 margin for our communications and services segment included a benefit from the timing of vendor program recognition.

The worldwide barcode and security gross margin decreased to 8.6% from 9% for the year-ago quarter, largely due to product and customer mix and a higher volume of big deals. For worldwide communications and services, the gross margin came in at 11.9% for the quarter, down from 12.7% for the year ago quarter, primarily due to the mix of business and last year's timing of vendor program recognition that did not recur.

SG&A expenses, excluding $1.3 million in acquisition cost, amortization of intangible assets and the change in fair value of contingent consideration, were 5.8% of net sales for the first quarter 2015 and 6.4% for the first quarter 2014. First quarter 2015 SG&A expenses included a $2 million credit for bad debt expense, which lowered SG&A expenses this quarter. This credit for bad debt expense is due to excellent collections and improved aging for our worldwide communications and services segment.

We acknowledge the hard work and dedication of our reseller financial services efforts over time to make these improvements happen for the quarter.

Since our last two acquisitions included earnout payments as part of the purchase price, each quarter we remeasure the fair value of our future earnouts related to acquisitions. The fair value adjustments, forecasted to be a loss each quarter, reflect the time value of the cash flow payments to be paid to the sellers of the acquired company.

In addition, these expected fair value adjustments can fluctuate based on changes in assumed discount rate, actual and forecast, operating results, foreign exchange rates, and other factors. In first quarter 2015, we recorded a fair value adjustment loss of $513,000 compared to a loss of $738,000 in the prior year quarter. We have one annual earnout remaining for CDC Brazil and two annual earnout payments for Imago. We would expect a fair value adjustment of approximately $350,000 for second quarter 2015.

Given the size of the acquisitions and potential variability of fair value adjustments on operating results, our non-GAAP results including ROIC exclude the change in fair value of contingent consideration. On slide 4 you will see first quarter 2015 non-GAAP operating income of $31.8 million, with a non-GAAP operating margin of 4%, slightly down from 4.1% for the first quarter 2014. Our first quarter 2015 GAAP operating income was $29 million with an operating margin of 3.7% compared to $28.2 million in the first quarter of 2014, with an operating margin of 3.9%.

For the worldwide barcode and security segment on slide 6, the non-GAAP operative margin was 2.7% for the first quarter 2015, down from 2.9% from the year ago quarter, principally from a lower gross profit margin. For the worldwide communications and services segment, on slide 7, the non-GAAP operating margin increased to 6.3% for the first quarter of 2015 from 5.9% from the year ago quarter. The credit for bad debt expense previously discussed more than offset the lower gross profit margin.

Our effective tax rate was 34.3% for the first quarter 2015, and 31.7% for the first quarter 2014. Our effective rate for the first quarter 2014 included a favorable timing adjustment related to state income taxes, which was recorded as a discrete item. We expect the effective tax rate for fiscal year 2015 to range between 34% and 34.5%.

Excluding the items previously discussed, first quarter 2015 non-GAAP adjusted net income was $21.6 million or $0.75 per diluted share compared to $20.5 million or [$0.73] (corrected by company after the call) per diluted share for the first quarter 2014. On a GAAP basis, net income for the first quarter 2015 totaled $19.2 million or $0.67 per diluted share.

Our return on invested capital, which excludes the change in fair value of contingent consideration and other non-GAAP adjustments, totaled 16.2% for the quarter compared to 17.4% and 14% in the prior year and sequential quarters, respectively.

Now, shifting to the balance sheet and some key metrics, cash and cash equivalents at September 30, 2014 were $139.9 million, down $55 million from the end of June. At September 30, 2014, we had a $5.4 million of debt, the same as a year ago, for an industrial development revenue bond for our distribution facility in Mississippi. Again, this quarter we had no borrowings from our $300 million credit facility. Combining our cash and credit facility, we have approximately $440 million available to fund future growth.

Days sales outstanding at September 30, 2014, excluding the impact of Imago ScanSource, remained at 55 days, in line with our prior quarters. Inventory levels, inventory turns, and paid for inventory days, as depicted on slide 8 of our presentation, are within our normal ranges and consistent with our current operating environment.

During the first quarter of fiscal year 2015, capital expenditures totaled $7.3 million, primarily for our ERP project. For fiscal year 2015, we expect total capital expenditures to be $17 million to $22 million, primarily for our ERP project. We plan to go live in Europe, our first go live date during the first half of fiscal year 2015 -- I'm sorry, during the second half of fiscal year 2015. We remain on schedule and on budget for this project.

As I mentioned last quarter, in addition to the capital expenditures and a level of operating expenses we have been incurring over the past nine months, we expect additional SAP-related ERP expenses in the second half of fiscal year 2015 of $5 million to $6 million. These expenses are for SAP implementation cost and training after the first go live and can no longer be capitalized for the project. Again, these costs will not be ongoing expenses for the Company. ERP-related expenses in the first quarter 2015 were not significant.

We believe we have significant resources and capital to grow the Company in the future while maintaining our high margins and high ROIC. Our capital allocation priorities include investing in organic growth for our businesses around the world and acquisitions that meet our strategic and financial goals.

Our planned acquisition of Network One, which we expect to close by the end of calendar year 2014, is structured with an initial purchase price plus earnout payments over the next four years. We expect to fund this acquisition from our cash on hand. We will continue to pursue strategic opportunities to invest in and grow our businesses, including additional acquisitions.

In August, the Board of Directors authorized a three-year, [$120 million] (corrected by company after the call) share repurchase program. We made no purchases during the quarter.

Turning now to our next fiscal quarter, we expect net sales for the quarter ended December 31, 2014 to range from $780 million to $800 million and non-GAAP diluted earnings per share to range from $0.64 to $0.66 per share. The non-GAAP diluted earnings per share excludes acquisition costs, and amortization of intangibles, and changes in fair value of contingent consideration. With that, I will turn the call back over to Mike.

Mike Baur - *ScanSource, Inc. - CEO*

Thanks, Charlie. Let me start with our worldwide barcode and security segment summarized on slide 10, which represented 63% of our overall sales for the quarter. Worldwide barcode and security sales of $501 million increased 11% year-over-year and 2% sequentially. We had a record sales quarter and double-digit growth for the segment for the second quarter in a row. We also had strong growth from our international POS and barcode business units with double-digit growth in Brazil, Europe, and Mexico.

Similar to fourth quarter 2014, it was a strong big deal quarter. As announced earlier, our largest barcode vendor worldwide, Motorola Solutions, was acquired by another of our large vendors, Zebra Technologies. As we already had been doing significant business with both firms since the early days of the Company's founding, we anticipate no surprises or negative changes to our relationship.

Our POS and barcode unit in North America had a record sales quarter, driven by big deals in retail system sales, and market share growth in our run rate barcode mobility, scanning, and printing businesses. The point of sale payments terminal hardware business had another quarter of strong double-digit [core] growth. We are seeing demand for EMV and NFC capable terminals increase, as retailers moved to adopt the more secure chip and pin technology in advance of the mandate from the credit card issuers in October 2015.

The retail reseller channel that we serve is becoming more and more involved in recommending, selling, and implementing these payment systems to the retail and hospitality end users as opposed to the traditional ISO channel that served retailers. The complexity of the new solutions and the integration between hardware and software require much more value-added support than in the past. We will continue to invest in this payment processing business to increase our value added services.

Our POS and barcode team in Europe had double-digit sales growth from both big deals and our run rate business. Sales across all product categories, mobile computers, scanners, printers, POS and wireless increased. By region, the United Kingdom had outstanding performance. It was a record quarter. And southern Europe started growing again as well.

In Brazil, our team had a record sales quarter and Brazil was our fastest-growing business unit. Brazil's growth reflects strong run rate business and double-digit growth from both point-of-sale and AIDC products. Each of Brazil's top 10 vendors grew year-over-year. New fiscal printer legislation has accelerated our point-of-sale printer market growth.

Turning to our security business in the US and Canada, this unit had 6% year-over-year sales growth led by double-digit year-over-year growth for our wireless networking. By product category, strength in networking and access control products offset lower video surveillance camera sales, where market growth had slowed in some areas. We're getting positive feedback on our ScanSource security on demand, an online education and information portal, and our Success Made Easy campaign.

Now just a few comments on 3-D printing, our newest technology business unit that we launched six months ago. Recruitment events for new resellers to join the 3-D systems channel continue to be a focus for our team. We are adding new customers from our existing barcode and point of sale customers looking for new market opportunities. And we are adding customers from the traditional computer-aided design reseller community who already know the target end customers. Our 3-D printing team hit their sales forecast for the quarter, but it is still early days for the development of the 3-D printing channel.

Now to worldwide communications and services on slide 11, which was 37% of overall sales this quarter. Worldwide communication and services net sales of $291 million increased 3% from a year ago and increased 9% sequentially. It was also a good sales quarter for the resale of vendor service contracts which have become recurring revenue for ScanSource and our channel partners.

ScanSource Communications in North America had another record sales quarter led by outstanding sales results with Polycom and ShoreTel. Our voice product sales continue to do very well and we recently added a new vendor barcode, a display hardware manufacturer including video walls as a new vendor in North America. In our channels, the service provider customers had a very good growth quarter.

ScanSource Catalyst hit its sales forecast for the quarter driven by higher enterprise sales and a record sales quarter with Cisco. With Cisco we are building momentum in collaboration sales and we have added new video partners. We are seeing good year-over-year growth also with Aruba Instant, including success with midmarket recruitment.

In Europe, we completed the acquisition of Imago late in the quarter. Imago was recognized by Polycom as its distributor of the year in Europe and we expect to spend time early in this quarter planning ways to leverage our two European communication teams.

ScanSource Services Group had a record quarter for hardware configuration services, both the number of units and number of customers. We continue to expand configuration services in support of our business unit sales efforts, particularly for IP, phone provisioning, and key injections for the point of sale terminal payment business. We also have a team certified and ready to implement the Cisco config to order program.

Our team had a good quarter for professional service offerings which support our customers in Wi-Fi services, network assessment, and voice and video implementations. We recently added a new Avaya training class for the IP office contact center solutions and are working on wireless certification classes.

So we had a strong start to our fiscal year 2015. We exceeded our expectations for sales and profitability and we are especially pleased to achieve a record quarter: 8% sales year-over-year growth and sales growth for both of our segments. In addition, the completion of our acquisition of Imago added a strong finish to the quarter.

We expect to update you at the closing of the Network One acquisition, which is currently estimated by the end of December. With that, we will turn it over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Chris McGinnis, Sidoti & Company.

Chris McGinnis - *Sidoti & Company - Analyst*

Nice quarter. Just to maybe just dig in a little bit deeper on the growth in North America, I guess some companies related to retail capital spending as a little bit more of a difficult time. Is it more about market share gains for you that is driving this? Or is it I guess just more deal growth that you are positioned for?

Mike Baur - *ScanSource, Inc. - CEO*

It's Mike. I will start here. I think the number thing for us was just we characterize this as a big deal quarter. And it came out of our barcode and POS business specifically, where we had very good growth on the retail side and our barcode business, so good growth there. We certainly had -- we were coming off of a strong June quarter as well, and so we were pleasantly surprised.

And I think part of it goes back to two quarters ago, when we talked about we had lost some market share in the March quarter. And it was one of our goals was to make sure that we could gain back market share where we met appropriate financial returns, and I believe we have done that. We had a good execution on the part of our North America sales teams taking share.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. And the strength in international markets, is that similar in terms of more market share gains than obviously what is happening in the underlying demand?

Mike Baur - *ScanSource, Inc. - CEO*

Yes, I think Europe itself was similar to North America in that we executed well. Our vendors are doing a good job with us. I believe the difference in those markets in Brazil, would be Brazil. There is some legislation that is helping us grow our fiscal printer business, in that new requirements for retailers to add fiscal printer technology is underlying the continued strong growth in Brazil, in addition to the same scenario we are finding in Europe and North America of, we are finding have the right vendor partners who themselves are gaining share. And we are gaining share within their distribution businesses.

So, overall, it was just a really good execution quarter. And in some cases where we were able to take some additional share, we felt like it was strategic for us because many of our vendors have programs that reward growth. And we want to make sure that we didn't lose out on that opportunity, which we had, frankly, three quarters ago.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. And just two quick questions on the quarter itself. You talked about a benefit from bad debt expense. I don't think that would carry forward, obviously. And is that kind of a onetime benefit for you?

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Yes. This is Charlie. That is correct. There was a [$2.1 million] (corrected by company after the call) credit in the quarter that will not -- we wouldn't expect that to carry forward in the next quarter.

Chris McGinnis - *Sidoti & Company - Analyst*

That wasn't backed out of the non-GAAP number. Is that correct?

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

That is correct. That was not backed out.

Chris McGinnis - *Sidoti & Company - Analyst*

All right. And going forward, when you gave Q3 guidance, or for the back half of the year, will you back out the extra expense for the ERP implementation?

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Well, we are certainly highlighting the fact that we are going to have these expenses, too. So you should be aware that we plan on having the $5 million to $6 million expenses.

The non-GAAP numbers that we disclosed for the quarter related to three primary areas. And that was the amortization of the intangibles, the change in fair value contingent considerations, and acquisition cost. Those we spelled out. So yes, I would not expect to exclude those as a non-GAAP number.

However, I do want to highlight for you that we have those expenses of which we do not believe we will be recurring in our business going forward.

Operator

(Operator Instructions) Keith Housum, Northcoast Research.

Keith Housum - *Northcoast Research - Analyst*

Good quarter. Charlie, the receivables are up $36 million compared to year-end. I think it might be a record of running roughly $500 million from what I remember about. What is driving that receivables, and is that perhaps just because sales are weighted toward the back end of the quarter?

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Yes. Absolutely. The receivable is up because of the strong sales, which normally occur at the back end of the quarter.

Keith Housum - *Northcoast Research - Analyst*

Okay so -- (multiple speakers)

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Our DSO numbers were consistent in that 55 days range, so there is no change there.

Keith Housum - *Northcoast Research - Analyst*

Okay. So does that lead us to believe that the sales in the quarter were strong (multiple speakers) to the beginning of this quarter. Correct?

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Let me also add one other thing on that is that we also have Imago, the acquisition, for the receivables in that number as well. So that was one of the other reasons why the receivables numbers were up, because of the acquisition of Imago.

Keith Housum - *Northcoast Research - Analyst*

Got it. Okay. Thanks. And in the unified communications business, it looks like the gross profit was down about $1 million compared to prior year. But the operating margin was up like $1.5 million. Is there anything going on in that business that perhaps stands out to you?

Mike Baur - *ScanSource, Inc. - CEO*

I will start first, Charlie, and then you can jump in. I think it is mixed. And that was the indication we gave in the call is that we had a different mix. And so when you look at our communication business as it has changed over the last few years, we have got other vendors now that are becoming stronger in that communications mix. And so that is what is changing the margin -- from a gross margin.

Keith Housum - *Northcoast Research - Analyst*

So I am assuming, since the -- but the higher operating margin you got less expenses going into it.

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Well, one of the things on the operating margin is the fact that we had the $2.1 million bad debt credit in that segment.

Keith Housum - *Northcoast Research - Analyst*

That is where it is. Okay.

Mike Baur - *ScanSource, Inc. - CEO*

Yes.

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Yes. You got it.

Keith Housum - *Northcoast Research - Analyst*

That makes sense, okay. Thanks. Your international sales obviously being strong, is that partly a function of the management restructuring you did last year as well? Is that helping the vendors to play better with you guys or what are your thoughts there?

Mike Baur - *ScanSource, Inc. - CEO*

I think overall it is execution. I think our teams are executing better. We have got more people involved in the international business. That was the design.

And there is certainly some benefit of the vendors recognizing us as now as more of a global player from their view rather than just a regional player. But I would say it is more the execution of the teams. And I think that is why this quarter we executed excellent in all those regions. And we have more management worried about how we are doing it in these markets. And I think we are seeing the results of that today.

Keith Housum - *Northcoast Research - Analyst*

Okay. As I look at your guidance for the second quarter, do I think about roughly $0.61 on a GAAP basis? Is that a good way to back into it?

Charlie Mathis - *ScanSource, Inc. - SVP, CFO*

Well, I think we gave you the non-GAAP number there, which, again, excludes the amortization of the intangibles, the fair value change in contingent considerations, and the acquisitions cost related to that. I think, going forward, we're going to give non-GAAP guidance, and so I don't have the GAAP guidance number for you right now.

Keith Housum - *Northcoast Research - Analyst*

Got it. And then I guess last question for you, we are hearing more and more about congestion on the West Coast and the ports with inventory coming in from Asia. Is that any potential impact on the vendors you guys serve?

Mike Baur - *ScanSource, Inc. - CEO*

We are certainly aware of those issues have been going on for quite a while. And I think our teams have not highlighted them as a concern they have to date. We, of course, have always had strong inventory positions and I would say, with the levels of inventory we have today, we are in good position to satisfy our customers even if there are some temporary shortages.

Operator

I'm showing no further questions at this time. I would like to turn the call back over to Mr. Mike Baur for any further remarks.

Mike Baur - *ScanSource, Inc. - CEO*

Thanks, everybody, for joining us today. We expect to hold our next conference call to discuss December 31 quarterly earnings results on January 29, 2015.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect.

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